

## APPENDIX

NOTES FOR F.O.M.C. MEETING  
August 18, 1981

Sam Y. Cross

Mr. Chairman, since the Committee's last meeting, one theme until this past week had been the strengthening of the dollar, which has moved higher against all currencies, up to levels not generally seen since 1976.

The net increases during the first five weeks of the six-week period had been, against the German mark, and currencies that move with it, more than 2-1/2 percent; against the yen, nearly 1 percent; against the pound sterling, nearly 5 percent; and against the Canadian dollar, more than 2 percent.

The dollar's continuing strength during that period was attributed to a broad range of economic and political influences. Let me comment on three factors:

First, interest rates. While some Europeans tend to exaggerate grossly the importance of this factor, continuing high U.S. interest rates are certainly one element of the picture. There seems little doubt in the exchange markets that U.S. rates will remain fairly high for a while, based on reasoning you are familiar with--the Fed's commitment to restrictive policy, the fiscal effects of the tax cut and higher defense spending, the heavy schedule of U.S. Treasury borrowing. There is also an expectation that if U.S. interest rates do decline somewhat the Europeans might be quick to follow, and thus the dollar might not be weakened much thereby.

Second, balance of payments. Although current account surplus of the United States, contrasted with deficits in continental Europe through the first quarter, underpinned the dollar's appreciation earlier, current account considerations do not appear to be a major factor in the exchange market at present and probably of much less importance than capital flows.

Third, political and security factors. These may be among the most important factors of all--at least they are increasingly cited in the market. We hear frequent comments about what is described as the market contrast between the United States, which is showing strong leadership and effective government, and is acting to improve its economy and strengthen its defenses, and Europe, where there are signs of what is seen as drift, divisiveness, and in some cases neutralism. Of course some central banks and others may be talking this way simply to put pressure on their own government. But it does look as though the incentives for political flows of capital are in one direction, with riots in the U.K., concern over Mitterrand's program in France, and events in Poland a constant reminder that Germany is potentially a frontier state. Even the U.S. decision on the neutron bomb was widely cited as having a strengthening effect on the dollar.

Against this background there have been periods of substantial intervention by other central banks, and markets sometimes characterized by a considerable amount of choppiness and uncertainty. Three situations are worth mention:

First, the German move for concerted intervention. On August 4 the Bundesbank mobilized the EMS members, plus Switzerland, in a concerted effort to

The participants, plus Japan, spent just under \_\_\_\_\_ and the rate stopped rising and in subsequent days declined somewhat. The Bundesbank described it as a major success but the other Europeans didn't say much.

to steady the market. In addition, the authorities acted to push up short-term interest rates and undertook to curb Canadian bank lending to finance takeover bids.

Third, the French have throughout August faced considerable speculative pressures. For some time there has been a view that there must at some point be a resetting of the EMS currencies, particularly the French and Belgian francs, and with Mitterrand's economic program the view has increasingly been that the change in the French franc would have to be substantial. Memories go back to 1969 when the franc was also overvalued, and during the August vacation period a devaluation caught almost everyone by surprise. Also, it is known that one of the main exchange controls changes imposed by France in May moved receipts ahead from the fall to the summer and this favorable impact will soon disappear. In light of these uncertainties, speculation against the franc has been heavy, costs of covering short positions have on occasion been very high, and Bank of France dollar intervention at times quite large.

The U.S. did not intervene during the six-week period. Other central banks intervened in dollars in substantial amounts--selling \$6-1/2 billion net.

On August 13, French Finance Minister Delors in a statement over French radio, said that the United States should intervene in the exchange markets "in order to check speculative movements in favor of the dollar." He referred to European action in intervening in November 1978, when the dollar was at its low level, to check speculation in favor of the dollar. We have not been explicitly asked to intervene by the French, the Germans, or any other central bank.

Particularly toward the end of the period, trading conditions in the exchanges deteriorated. By August the markets were thin and had lost considerable resiliency. With the exchange rate volatility they've experienced, traders seem more apt to withdraw even in the face of relatively unimportant developments. We have experienced an increasing frequency of airpockets in various currencies. The dollar, which had been strong earlier, hit several of these down slides in the past week and has fallen from 2.57 DM to about 2.47 DM, a fall of 4%.

One of these airpockets took place on August 12, when in terms of DM, the dollar rate fell during a half-hour period from 2.52 to nearly 2.47, a decline of 2 percent. The move coincided with efforts to cover French franc positions, but there was no clear explanation as to what initiated the slide. Nevertheless, once underway, it seemed to snowball as dealers in the interbank market joined in to unload long dollar positions created by the substantial European intervention of previous days. Another such event took place yesterday.

Once again rates fell about 2%. And this has continued today. Since these episodes do not appear to be clearly related to developments in other markets, these experiences have had an unsettling effect. Dealers were left with a view that they are operating in a market that can be fragile, disorderly, and jumpy, and little can be taken for granted.

In this environment, exchange markets may have a rocky road ahead, and it is worth thinking about the competitive position of the dollar, particularly vis-a-vis the mark. At today's exchange rates, most would forecast a very large current account deficit for the U.S. next year, and improvement in Germany. This has not been reflected in the market perhaps because the cost of financing a short dollar position is high. There is still a favorable attitude toward the dollar, partly because of an improved inflation outlook, partly because capital inflows are expected to continue strong. The market is unsure whether a peak for the dollar has been reached, but if a convincing turn is sighted, the dollar could experience a substantial free fall.

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Recommendation

Mr. Chairman:

At its March meeting the Committee reviewed its informal understanding concerning the amount of balances held in foreign currencies and reaffirmed that no more than \$2,750 million would be held in German marks. As of August 14, the System had mark balances (valued at cost) of \$2,710 million, just \$40 million short of the authorized amount. We have not added marks to balances through market operations, as you know. But our balances increase as we receive interest on mark holdings. Looking ahead, we expect to receive another, sizable amount of interest around end-August, when funds that the System warehoused for the Treasury are disinvested to permit the Treasury to pay off the first of its maturing DM-denominated "Carter bonds." To provide leeway for this interest receipt as well as subsequent interest earnings, I recommend that the amount of balances to be held in all currencies be raised from \$4-1/4 billion to \$4-1/2 billion in order to accommodate an increase in the amount to be held in German marks from \$2-3/4 billion to \$3 billion. Assuming no change in the expected timing of interest receipt and no change in the level of short-term German interest rates, this increase would be sufficient to provide for interest earnings over the next six months or so.

Reporting on open market operations, Mr. Sternlight made the following statement:

For a short time after the July 7 meeting, it looked as though both narrow and broad money aggregates were running ahead of the Committee's desired path, thus tending to produce a level of discount window borrowing above the \$1,500 million level used in constructing the nonborrowed reserve path. By the latter part of July, growth in the aggregates weakened, producing a July expansion in M-1B considerably below path and in M-2 just slightly below path. As this unfolded, the implied level of borrowing receded from somewhat above \$1,500 million to somewhat below. A fresh surge in the aggregates appeared in early August but given lagged reserve accounting, it has had only limited impact on reserve demands and borrowings up through the current week.

While the level of borrowing implied by achievement of the nonborrowed reserve path moved in a fairly narrow range over the period--from about \$1,650 million to \$1,350 million, and most recently about \$1,400 million, actual borrowing levels covered a broader span, with weekly averages ranging from nearly \$2 billion to about \$1.1 billion. The higher borrowing levels were in the earlier part of the interval, broadly consistent with the higher anticipated levels at that time, but there was a good deal of short-term variability in borrowing--in fact, sufficient on one occasion to call for adjustment to the reserve paths in order to avoid imposing variations in reserve pressure inconsistent with unfolding information on monetary aggregates.



Corresponding roughly with the decline in reserve pressure over the period, the Federal funds rate came down over the period, but only rather grudgingly--from the 19-20% area in early July to around 18 1/4 in the first two weeks of August. So far this week, funds averaged about 17 3/4, but the rate pushed back above 18% yesterday. The stubbornness of the funds rate was a disappointment to many market participants who hoped to see the moderation of the aggregates followed by more visible evidence of slackening reserve pressures. No single factor seems to explain the relatively high funds rate, but at various times in the period one may cite as reasons some evidence of reluctance to borrow, fairly high demands for excess reserves, sizable dealer financing needs, and churning and uncertainty associated with corporate takeover activities. Also, through much of the period, another factor may have been the \$2 billion of Iran-related funds lodged at the Fed, requiring continuing Desk efforts to offset their reserve impact.

In the first 3-week subperiod, ending July 29, total reserves turned out about \$80 million above path, mainly reflecting high excess reserves, while nonborrowed reserves were about \$85 million below their path. In the second 3-week subperiod, it appears that total reserves may average about \$160 million below their path while nonborrowed reserves should come close to path. Starting this week, we are counting as nonborrowed reserves the extended credit borrowing from the Fed by thrifts. It's expected to be just \$45 million this week but could grow substantially.

The System made sizable net outright purchases of securities during the intermeeting period to counter the effect of market factors absorbing reserves and provide for reserve growth in line with path objectives. The System bought over \$3 billion of bills, including nearly \$1.4 billion in the market and the rest from foreign accounts; also, nearly \$1 billion of Treasury coupon issues was bought in the market. There was a partial offset in that \$100 million of bills were redeemed when it looked like the Iranian funds would soon be moved out. The net rise of nearly \$4 billion in outright holdings required an increase in the leeway for change in the System Account, which the Committee approved in early August. There was also substantial use of repurchase agreements to inject funds day-to-day--more actively than in other recent periods largely due to the Iran-related funds, about which there was much uncertainty as to when they would flow out. My latest information is that these funds are finally moving out today--with no regrets from the standpoint of our domestic trading desk.

Despite the somewhat lower funds rate, most market interest rates worked higher during the period, setting new records in the intermediate and longer areas. The weight of Treasury financing, current and prospective, was a persistent adverse factor. The market kept looking for some weakening in short-term rates in the wake of soft money numbers but, as mentioned earlier, the funds rate gave ground only grudgingly and this was a disappointment. The strength of System intentions to stay the course in winding down money growth was underscored

by release of the May policy record in early July, and by Chairman Volcker's Congressional testimony later in the month. In this setting, investors were content to hold back their buying, shrugging off some indicators of business weakness and moderating inflation. Sentiment reached a particularly low ebb with the approach of the Treasury's August financing, announced July 29. The size of the coupon package was to the high side of the expected range, while the Treasury's anticipated fourth quarter needs of \$30 - \$33 billion generally exceeded expectations. Good bidding developed at the record high market yields that emerged, however. For a while after the auctions the new issues developed fairly good-sized premiums, although these have faded back in the final days of the period. Net over the interval, yields on intermediate-term coupon issues rose about 1/2 to 1 1/2 percentage points, while long-term yields were up about 1/2 percentage point. For the period, the Treasury raised over \$5 billion in coupon issues. Another \$1.6 billion will be raised through a 2-year note sale this Thursday, which could set another record for Treasury coupon yields based on current prices.

Federal agencies have also had to pay record rates, and their yield spreads against Treasury issues have continued to widen, especially for FNMA and Home Loan issues, as investors have had some qualms about credit quality and volume of issuance. Yields on corporate and tax-exempt issues also pushed to new highs, although volume of new issues tapered off because of the high costs to borrowers. Some of the price erosion for tax exempts

can be traced to the new tax legislation which lowers Federal tax rates and introduces the new all-saver tax-exempt certificate.

In the short-term area, bill rates rose about 1 to 1 1/2 percentage points on key issues, though remaining below record levels. Yesterday, 3- and 6-month bills were auctioned at about 15.70 and 15.64 percent, respectively, compared with 14.40 and 14.05 percent on July 6. For the 6-month issue, yesterday's rate was near record. The Treasury has also raised new cash in the bill area, about \$3.6 billion over the period.

A noteworthy development in the Government securities market during the period was the announcement that Salomon Brothers, long a leading dealer, would be acquired by Phibro, a major international commodities trading firm. The news, which came out in the midst of the Treasury refunding, disturbed the market at first, as there were fears that Salomon might have incurred big losses and might pull back from its major market role. The firm has denied the reports of losses and stated its intention to remain an active market participant--as indeed they demonstrated during the refunding.

Joseph S. Zeisel  
August 18, 1981

FOMC BOARD BRIEFING

The economy appears to have been moving sideways over the past few months, maintaining a precarious balance in the face of intense pressure on the more credit-sensitive sectors. The two percent decline in real GNP in the second quarter reflected erosion of a wide range of activities, but most fundamentally of housing and auto sales. The outlook for these sectors remains bleak, but there has been no evidence of a cumulative decline in aggregate activity, and on balance, we are forecasting virtually no change in real GNP in the current quarter. We anticipate that, consistent with existing monetary policy constraints--tightened somewhat at the last FOMC meeting--the economy will continue to grow at a sluggish pace over the projection period. Of course, this outlook is not inconsistent with the occurrence of one or more negative quarters over the next year.

Taken at face value, the recent behavior of employment does not suggest any substantial weakening of activity in the near term. Indeed, the labor market showed surprising strength in July. After several months of very slow growth, employment in nonfarm establishments rose by 385,000--the largest one-month gain in the past year. Increases were reported in most major industries with the exception of construction. Manufacturing employment rose briskly with a strong gain in the capital goods industries. The household survey figures also showed strength, and the unemployment rate fell 3 tenths to 7 percent--the lowest rate in more than a year.

In fact, the vigor suggested by these figures seems out of line with overall demands, as reflected in other data and reports in the Redbook. Industrial output in July is estimated to have risen by three tenths percent, following a slight decline in June, but most of the July rise reflected a continuation of the post-strike rebound in coal output. Production of autos and trucks was cut back and output of construction supplies dropped, while business equipment continued to grow. Essentially, industrial production has been on a plateau for the past few months.

Although auto production has been at depressed levels for some time, assemblies in July at a  $7\frac{1}{4}$  million unit annual rate were still  $1\frac{1}{4}$  million, annual rate, above sales; the stock of cars in dealers hands at month-end totaled 87-day supply (and about 60 days is considered desirable). As a result, auto manufacturers have reduced their scheduled assembly rates further for the next several months--cutting mainly production of 1982 models. In addition, they all introduced new sales incentive programs of one sort or another in early August. This had the effect of boosting sales in the first 10 days to a  $7\frac{1}{4}$  million annual rate after 4 months of an under 6 million sales pace. But it's likely to involve merely a borrowing of sales from the future, and suggests weaker demand for 1982 models later this fall. Given the probable sluggishness of real income growth, substantial auto price increases and heavy financing costs, we anticipate only a modest improvement in car sales over the projection period.

Aside from the gyrations of auto demand, retail sales have been quite sluggish, remaining nearly unchanged since March in current

dollar terms, and of course weaker in real terms. We project a somewhat improved rate of growth of consumer outlays generally in response to the tax cuts, but as with cars, demand for most larger consumer durables is likely to continue to be constrained by taut financial conditions.

Activity in the housing market slowed further recently as financial markets tightened. Starts dropped in June to a one million rate, and sales of new houses fell precipitously to a level just above the low points of 1966 and 1970. We expect starts to remain in the one million range for the balance of this year and to improve to only about a 1¼ million rate in 1982 in spite of the substantial strength of underlying demographic forces. Although mortgage interest rates are projected to decline a bit, they should remain very high historically, and given the likely caution of lenders, even the weak level of housing activity projected will require a considerable volume of creative financing.

Real spending for business fixed investment has also slipped in recent months following a surge early in the year. The slowing has been widely evident--in capital goods shipments, in business purchases of motor vehicles and in construction. Indicators of future investment outlays suggest further sluggishness over the near term. New orders for nondefense capital goods fell 2.9 percent in real terms in June for the third consecutive month of decline. Real business outlays are expected to trend down throughout the projection period, reflecting the substantial margin of unused capacity and the high cost of capital.

The new accelerated depreciation schedules are expected to have only a slight impact on capital spending through 1982.

In terms of overall activity, this adds up to the prospect of little or no gain in real GNP over the next four quarters. However, we expect a modest pickup in growth, to the 2 to 3 percent annual rate range, in the latter half of next year. At that time, fiscal policy becomes quite stimulative with the second stage of the tax cut, while reduced inflation will have provided a basis for increased economic growth within the assumed monetary policy constraints.

The inflation picture has looked more favorable recently. Although much of the price improvement has occurred in food and energy, excluding these sectors and homeownership costs, the CPI increased at an  $8\frac{1}{2}$  percent rate in the first half of 1981 compared with a 10 percent rise in 1980. More important, there appears to have been some slowing of wage increases this year, particularly in the more heavily unionized manufacturing sector. It is true that we may well have seen all of the price improvement we are going to get in 1981. We expect some pickup in energy prices later this year, and food prices are already showing signs of reaccelerating, as shown by the July PPI figures. But we expect costs and price increases overall to continue to decelerate in 1982 in an environment of increased slack in labor and product markets. There should also be significant benefits from the substantial appreciation of the dollar. As a result, we are now forecasting the gross business product fixed weighted price index to slow from an 8 percent rate in the second half of this year to about a  $7\frac{1}{2}$  percent pace in the latter half of 1982.



FOMC BRIEFING  
Stephen H. Axilrod

August 18, 1981

Data for the aggregates in early August suggest the probability of a resurgence in growth of both M1-B and M2 this month. Some rebound in M1-B growth would seem to be welcome in view of the sizable distance of that aggregate below the Committee's annual target range. But a resurgence of M2 could well bring it above the FOMC's longer run range, and thereby make more urgent the question of whether M2 should receive added weight in setting reserve paths to guide the day-to-day conduct of policy.

Whether priority should be placed more on M1-B or M2 in a situation in which one or both are outside their range fundamentally depends, of course, on which bears the closest relationship to the Committee's ultimate economic objectives over the long-run, and on which may be subject to special factors over the near-term that need to be discounted. Over the years, I do not believe the economics profession has been able to demonstrate conclusively--among the other things it has not been able to so demonstrate--which is the best monetary aggregate to control. In this period of rapidly changing financial technology, the problem becomes even more difficult.

M1-B has obvious disadvantages at present. To discover whether it is on target or not depends on estimates of funds shifted into NOW accounts from nontransactions accounts, a difficult estimating procedure at best. Moreover, with continued high interest rates serving as a strong incentive, the public may well be economizing on transactions accounts generally. If the money demand equation in the quarterly econometric model is to be given any credibility, there was a downward shift in money demand in the first half

of 1981 at more than 5 percent at an annual rate (apart from shifts into NOW accounts from nontransactions accounts). If that were added to the shift adjusted growth of M1-B over the first half, growth in M1-B, judged in terms of its economic impact, could be taken to be around 7-1/2 percent. This may well be an exaggeration, though, since other equations would not show so substantial a downward shift; moreover, the Committee can be said to have allowed for a downward shift (though not so large a one) in setting the annual target for M1-B. But it does suggest that weakness in M1-B relative to target should have been discounted to an extent in policy operations (as indeed it was).

Because M1-B has disadvantages at present, it does not automatically follow that M2 has become more advantageous, or even relatively more so. In general, that aggregate has always been subject to distortions from shifts in the public's savings as interest-rate relationships change or even as the distribution of income between consumption and savings changes. And it has not been clear why long-term time certificates that cannot be cashed without large penalties should be treated as money rather than as investments. In addition, the further erosion of interest-rate ceilings with the DIDC action lifting the cap on the small saver certificate effective August 1, the advent of the all savers certificate on October 1, and the apparently increasing use of consumer RPs by depository institutions (which are presently not in M2 but in M3) all suggest that financial innovations and regulatory change can be having distorting effects on broader aggregates.

Still, given the uncertainties about all the aggregates, it is probably desirable not to ignore M2, though it would be difficult, in my view, to make a case for attending only, or mainly, to that aggregate. It still

seems to me that the aggregate to control is the one for which it is least easy to develop substitutes that vitiate the effectiveness of control and that bears a close relationship over time to ultimate economic targets. A transactions aggregate would seem more to have those characteristics than a broader aggregate--though the advent of money market funds is only the most obvious evidence that very direct substitutes for narrow money are becoming increasingly available as the monopoly of the depository system (including the Federal Reserve) in supplying what is in effect narrow money is in the process of breaking down.

If the Committee were to achieve the lower end of its long-run target range for M1 by the fourth quarter, it would require just about an 8 percent annual rate of growth over the last five months of the year. The staff believes that, given our GNP projections, demand for money will be strong enough to require continuing restraint on credit market conditions if M1 growth is to be kept to 8 percent. Our view assumes, essentially, no further downward shift in money demand from this point. But it is also very likely that such M1 growth--should it develop--will involve relatively rapid growth in M2. The nontransactions component of M2 has expanded at about a 10-1/2 percent annual rate since the beginning of the year, and at about a 9-1/2 percent annual rate in the month of July, following relatively slow growth in May and June. Should growth in that component over the balance of the year be around 11 percent, roughly what we've assumed in alternative A, and M1-B grow at 8 percent, M2 would expand at almost a 10-1/2 percent annual rate from July to December, and reach a 9-1/2 percent rate for the year.

If the Committee did not wish to see M2 move above its range, it would have to restrain M1-B growth to a quite low annual rate over the balance of the year--perhaps in the 3 to 6 percent area depending on the behavior of the nontransactions component of M2 as narrow money is restrained. Unless there were a further downward shift in narrow money demand (and I wouldn't discount the possibility entirely), such a policy course would exert further upward pressure on interest rates in the short-run and downward pressure on GNP.

Of the two alternative specifications before the Committee, alternative B moves in the direction of restraining M1-B in an effort to curb M2, while alternative A seems more consistent with permitting M2 to move somewhat above its long-run target should that develop. Of the two directive languages, the language of alternative II would facilitate a policy of adopting more restraint on M1-B growth over the near-term in an effort to curb M2 growth; it would permit more rapid growth in M1-B to the extent that M2 was within target. The language of alternative I retains the approach taken by the Committee at the last meeting. It would be consistent with retaining the present third-quarter M1-B target path adopted at the last meeting--or even lowering it for that matter--but it would have to be recognized that strength of M2 might quickly trigger the proviso clause and require aiming at a lower M1-B growth, unless the proviso clause were adjusted by the Committee on policy grounds.